

AR77

Windsor University
2004-2005
2005 Business
Education, Accredited

SHEER ENERGY INC.

2004 Annual Report

CORPORATE PROFILE

Sheer Energy Inc. is a publicly traded oil and gas exploration and production company. Approximately 83% of the Company's revenues are derived from gas production.

FINANCIAL SUMMARY

Years ended December 31	2004	2003**
Total Revenue (net of royalties)	553,358	629,386
*EBITDA	58,462	142,260
*Cash Flow from (used in) operations	(65,942)	60,929
*Cash Flow from (used in) operations per share	(0.01)	0.01
Earnings (loss) before discontinued operations	(21,083)	(5,448)
Earnings (loss) per share from continued operations	0.00	0.00
Capital Expenditures	75,164	50,166
Common Shares outstanding at December 31	6,557,863	6,057,863

* EBITDA and cash flow from operations and per share are not recognized measures under Canadian generally accepted accounting principles (GAPP).

** The amounts for the year ended December 31, 2003 have been restated to incorporate the effects of the change in accounting policy for asset retirement obligations and for discontinued operations.

ANNUAL MEETING

The Annual Special Meeting of Shareholders of Sheer Energy Inc. is to be held at 3:00 p.m. on Thursday, September 8, 2005, at the offices of Fraser Milner Casgrain LLP, 30th Floor, Fifth Avenue Place, 237 – 4th Avenue S. W., Calgary, Alberta.

Forward-Looking Statements

This annual report includes forward-looking statements regarding Sheer's operations, anticipated financial performance, business prospects and strategies. Forward-looking information may involve words such as "believe", "expect", "anticipate", or similar words implying future outcomes. Readers are cautioned not to place undue reliance on forward-looking information because it is possible that predictions, forecasts and other forms of forward-looking information will not be achieved by Sheer Energy Inc. Sheer Energy Inc. is under no obligation to update publicly or otherwise revise any forward-looking information.

PRESIDENT'S MESSAGE

We are pleased to report that the previously announced Reverse Takeover transaction with Rigo Oil Company et al is proceeding satisfactorily, albeit slowly. The regulatory material has been filed with the TSX Venture Exchange and we are presently awaiting their comments. Most of the documentation for the closing of the transaction has either been completed or will be completed in the near term and, pending regulatory approvals, we should be in a position to close. We view this transaction as a positive one for the shareholders and expect that the patience of our shareholders will be duly rewarded in the near and longer term.

The Annual Special General Meeting of the shareholders is scheduled to be held in Calgary on September 8, 2005.

We are extremely pleased that we were able to implement the dividend and return of capital payments to the shareholders, resulting from the sale of Sheer Energy (Cyprus) Limited, prior to the end of the 2004 fiscal year.

Sincerely,



T.D. Lawrence
President and C.E.O.

August 8, 2005
Calgary, Alberta

CANADIAN OPERATIONS REVIEW

The Company's net average daily production for 2004, expressed in barrels of oil equivalent per day (boe/d), was 39.13 boe/d (for a cumulative production of 14,282 boe during the year) versus 58.5 boe/d in the previous year. The decline in production is mostly due to a failed recompletion attempt in December 2003 of one producing gas well in the South Edson Unit No. 1 which brought in water from a lower horizon. ConocoPhillips, the operator of the South Edson Unit, has proposed the drilling of two additional locations in an attempt to increase production from the Unit. The daily production, expressed in boe/d, is based on the industry standard conversion factor of 6 Mcf equalling one barrel of oil.

An evaluation of the remaining recoverable reserves and the net present value attributable to five of Sheer's unitized properties was completed by Fekete Associates Inc. at December 31, 2004. An independent appraisal of Sheer's properties operated by Signalta Resources Limited was conducted by Matsalla Consulting (1981) Ltd.

Fekete Associates Inc. has assigned a 10% net discounted present value of \$1,035,900 to the proved producing and proved non-producing reserves at December 31, 2004.

Remaining recoverable reserves, net to Sheer after royalties, as evaluated by Fekete amount to 436,000 Mcf of natural gas and 25,500 barrels of oil and natural gas liquids. Production during the year stood at 25,500 Mcf of natural gas and 3,463 barrels of oil and natural gas liquids.

Appraisal by Matsalla Consulting (based on a report by DeGolyer and MacNaughton) of approximately 209 gas and oil wells operated by Signalta Resources indicates that the remaining recoverable reserves, net after royalties, for Sheer's interest in such wells are in the order of 245,000 Mcf of natural gas and 3,058 barrels of oil and natural gas liquids, having an estimated net present value of approximately \$627,000 at a 10% discount rate.

Total remaining recoverable reserves, net after royalties, from all of Sheer's properties are therefore approximately 681,000 Mcf of natural gas and 28,558 barrels of oil and natural gas liquids, equivalent to 142,058 boe, with a combined net present value at a 10% discount of approximately \$1,662,900.

The following table summarizes the net present value and the total remaining proved plus probable reserves, net after royalties, of all the combined Canadian properties owned by Sheer.

Net present values are provided for the forecast escalated cost and prices case. Remaining reserves also refer to the forecast escalated cost and prices case.

NET PRESENT VALUE		REMAINING RESERVES	
(Escalated Costs and Prices)			
@ 0%	\$2,939,249	GAS (Mcf)	681,000
@ 10%	\$1,662,735	OIL (bbls)	21,113
@ 12%	\$1,529,669	NGL (bbls)	7,445
@ 15%	\$1,367,017		

Following is a brief description of the units evaluated by Fekete Associates Inc.

SOUTH EDSON GAS UNIT NO. 1

Sheer has an 8.9688% working interest in the South Edson Gas Unit No. 1 located west of Edmonton. The Unit covers 45,120 gross acres of land and produces gas from the Elkton-Shunda formations. Two wells are currently on production and six wells are shut-in or suspended. The 10-17-50-16 W 5M well, which contributed about 60% of the unit gas production, was suspended in early 2004 after a workover attempt to improve production resulted in unexpected and excessive water production from a lower horizon. A new well (12-16-50-16 W5M) is scheduled to be drilled and completed in October 2005 and another well at 11-26-50-17 W5M is scheduled to be drilled and completed in November 2005.

HARMATTAN EAST UNIT NO. 1

The Company holds a 1.014525% working interest in oil production and a 0.13331% working interest in natural gas production from the Harmattan East No. 1 Petroleum Unit and a 0.13331% working interest in the natural gas production from the Harmattan East No. 1 Natural Gas Unit. The Petroleum Unit commenced production in 1961 and currently consists of 21 producing wells and 13 water injectors. The Natural Gas Unit has 22 producing wells and three gas storage wells.

ADDITIONAL PROPERTIES

Sheer holds minor working interests in three other oil units, namely Cynthia Cardium Unit No. 4, Snipe Lake Beaverhill Lake Unit No. 1 and Wainright Unit No. 6. The Company's working interest in these three units ranges from 0.076% (Snipe Lake and Wainright) to 0.32% (Cynthia).

MANAGEMENT'S DISCUSSION & ANALYSIS

The Management's Discussion and Analysis ("MD&A") should be read in conjunction with the audited consolidated financial statements and MD&A for the years ended December 31, 2004 and 2003. This MD&A contains "Forward-Looking Statements". Please see the disclaimer on the inside front cover of the Annual Report.

In certain tables, this MD&A presents results on a boe basis, which may be misleading if used in isolation. All boe conversions in this report are calculated by converting natural gas to oil in the ratio of six thousand cubic feet of natural gas to one barrel of oil.

PRODUCTION

Years ended December 31	2004	2003	2002
Crude oil (bbls/d)	7.2	9.7	8.3
Natural gas liquids (bbls/d)	3.6	5.6	5.5
Total liquids (bbls/d)	10.8	15.3	13.8
Natural gas (boe/d)	28.5	43.2	44.5
Total (boe/d)	39.3	58.5	58.3

Average daily production of barrels of oil equivalent for 2004 declined to 39.3 boe/d from 58.5 boe/d during the year ended December 31, 2003. The decrease in production volumes in 2004 was primarily as a result of a reduction in production at South Edson combined with normal productivity declines in other properties.

FINANCIAL PERFORMANCE**Selected Annual Information**

Production volumes are based on the daily production which resulted in revenues to the account of Sheer Energy Inc. The total net production to the account of the Company in 2004 was 14,243 boe. Total net production in the 2003 fiscal year was 21,352 boe.

Twelve months ended December 31	2004		2003	
			(restated) ^{1, 2}	
	\$	\$/boe	\$	\$/boe
Oil and gas revenue	584,504	41.04	767,889	35.96
Royalties net of ARTC	(99,537)	(6.99)	(138,541)	(6.49)
Interest and consulting fees	68,391	4.80	38	0.00
Total net revenue	553,358	38.85	629,386	29.47
Amortization, accretion & depletion	76,397	5.36	113,455	5.31
Operating costs	154,373	10.84	203,036	9.51
General & administration ³	340,523	23.91	284,090	13.30
Interest	15,634	1.10	24,571	1.15
Income taxes – current (recovery)	(26,942)	(1.89)	33,682	1.58
Income taxes – future	14,456	1.01	(24,000)	(1.12)
Net earnings (loss) before income from discontinued operations	(21,083)	(1.48)	(5,448)	(0.26)

1. Restated to reflect the change in accounting policy with respect to Asset Retirement Obligations – See Notes 2 and 11 to the audited financial statements.

2. 2002 results have not been presented as the statements were not revised to conform to the 2003 and 2004 presentation.

3. General & Administration Expense includes a provision amounting to \$16,369 (\$0.77/boe) for stock based compensation in 2003.

Summary of Quarterly Results

	Q4 2004	Q3 2004	Q2 2004	Q1 2004
P&NG sales net of royalties	\$ 120,151	\$ 121,944	\$ 144,042	\$ 98,830
Net income (loss) from continuing operations	96,693	(78,872)	(5,143)	(33,761)
Income (loss) per share basic and diluted from continuing operations	0.015	(0.01)	0.00	(0.01)
Earnings (loss) from discontinued operations	(127,019)	2,848,050	(109,656)	—
Basic & diluted earnings (loss) from discontinued operations per share	(0.02)	0.47	(0.02)	—
	Q4 2003	Q3 2003	Q2 2003	Q1 2003
P&NG sales net of royalties	128,107	163,414	138,286	199,541
Net income (loss) from continuing operations	(9,131)	(31,320)	20,116	14,887
Income (loss) per share basic and diluted from continuing operations	0.00	(0.01)	0.00	0.00
Earnings (loss) from discontinued operations	(97,739)	16,214	(17,647)	—
Basic & diluted earnings (loss) from discontinued operations per share	(0.02)	0.00	0.00	—

Oil and Gas Revenue

Oil and gas revenue per boe increased by 14% due to significantly higher crude oil and natural gas prices experienced during the 2004 fiscal year compared to the preceding year, while overall production revenue declined by 24% primarily as a result of reduced production volumes.

Amortization, depletion and accretion on a per boe basis was consistent with that of the preceding year but was reduced on an absolute basis due to decreased production in 2004 compared to 2003.

The loss before income from discontinued operations for the fiscal year 2004 amounted to \$1.48 per boe compared to a loss of \$0.26 per boe in 2003.

General and Administrative Expense

General and administrative expenses increased by \$56,433 from the preceding year primarily as a result of increased legal and accounting costs associated with the sale of Sheer Energy (Cyprus) Limited and the payment of the Shareholders Dividend and Return of Capital.

DISCONTINUED OPERATIONS

The sale of the Company's wholly owned subsidiary, Sheer Energy (Cyprus) Limited had a significant impact on the 2004 financial results. The proceeds resulted in net income from discontinued operations of \$2,611,375 and resulted in a year end profit of \$2,590,292 (\$0.423 per common share). This was a one-time event.

DIVIDEND AND RETURN OF CAPITAL

On October 20, 2004 the Board of Directors approved the payment of a special dividend of \$0.25 per common share payable to shareholders of record on November 18, 2004. At a Special Meeting of Shareholders, held on December 7, 2004, the payment of a "return of capital" was approved. The payment was made on December 31, 2004 to shareholders of record on December 17, 2004. Both of these payments are fully reflected in the December 31, 2004 financial statements. Both of these payments were one-time events and therefore are not expected to be repeated.

LIQUIDITY AND CAPITAL RESOURCES

The sale of Sheer Energy (Cyprus) Limited had a very beneficial impact on the Company's current position which was (\$1,143,649) at December 31, 2003 and \$89,707 at December 31, 2004 after payment of the dividend and

return of capital. The Company also has an operating line of credit with its bankers in the amount of \$150,000 which was undrawn at December 31, 2004. At December 31, 2004 the Company was indebted to its principal bank with respect to an office condominium mortgage in the amount of \$113,083 (2003 \$48,323).

The Company has sufficient funds, cash flow from operations and available line of credit to allow it to meet its obligations on a timely basis for the foreseeable future.

APPLICATION OF CRITICAL ACCOUNTING ESTIMATES

The significant accounting policies used by Sheer are disclosed in note 2 to the Consolidated Financial Statements. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. The following section discusses such accounting policies and is included in Management's Discussion and Analysis to aid the reader in assessing the critical accounting policies and practices of the Company and the likelihood of materially different results being reported. Sheer's management reviews its estimates regularly. However, the emergence of new information and changed circumstances may result in actual results or changes to estimated amounts that differ materially from current estimates.

The following assessment of significant accounting policies is not meant to be exhaustive. The Company might realize different results from the application of new accounting standards promulgated, from time to time, by various rule-making bodies.

Oil and Gas Reserves

New definitions of reserves became effective for 2003 as outlined under National Instrument 51-101 ("NI51-101"). Under NI51-101 "Proved" reserves are those reserves that can be estimated with a high degree of certainty to be recoverable (it is likely that the actual remaining quantities recovered will exceed the estimated Proved reserves). In accordance with this definition, the level of certainty targeted by the reporting company should result in at least a 90% probability that the quantities actually recovered will equal or exceed the estimated reserves. Previously, there was no such consideration of probability. In the case of "Probable" reserves, which are obviously less certain to be recovered than Proved reserves, NI51-101 states that it must be equally likely that the actual remaining quantities recovered will be not less than the sum of the estimated Proved plus Probable reserves. With respect to the consideration of certainty, in order to report reserves as Proved plus Probable, the reporting company must believe that there is at least a 50% probability that the quantities actually recovered will equal or exceed the sum of the estimated Proved plus Probable reserves. The implementation of NI51-101 has resulted in a more rigorous and uniform standardization of reserve evaluation.

The oil and gas reserves estimates are made using all available geological and reservoir data as well as historical production data. Estimates are reviewed and revised as appropriate. Revisions occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Company's plans. The effect of changes in proved oil and gas reserves in the financial results and position of the Company is described under the heading "Full Cost Accounting for Oil and Gas Activities".

FULL COST ACCOUNTING FOR OIL AND GAS ACTIVITIES

Depletion and Amortization, Ceiling Test and Asset Retirement Obligations

The reader is encouraged to refer to "Note 2, Significant Accounting Policies: Capital Assets, Ceiling test and Asset retirement obligations" in the Consolidated Financial Statements to determine the Company's policies in these respects.

NEW ACCOUNTING STANDARDS FOR 2005

At this time, there are no new accounting standards expected to affect the Company in 2005.

CONTINUOUS DISCLOSURE OBLIGATIONS

Effective March 31, 2004, the Company and all reporting issuers in Canada became subject to new disclosure requirements as per National Instrument 51-102 "Continuous Disclosure Obligations". The new instrument was effective for fiscal years beginning on or after January 1, 2004. The instrument proposed enhanced disclosure in the annual and interim financial statements and MD&A. Under this instrument, it is no longer mandatory for the

Company to mail interim financial statements and MD&A to shareholders, but rather these documents will be provided on an "as requested" basis. Annual financial statements and MD&A will be provided to shareholders unless a shareholder requests not to receive these documents. It is Sheer's intention to make these documents available on the Company's website on a continuous basis.

OUTLOOK FOR 2005

The operator of the South Edson property has proposed two recompletions as well as the drilling of two additional infill wells during 2005. South Edson is one of the Company's most significant producing assets and the loss of production from one well as previously reported resulted in a marked reduction in Sheer's production. Success with some or all of the proposed recompletions and new wells could be beneficial to Sheer's production base and cash flow in 2005.

As reported on January 7, 2005, and following subsequent adjustments and amendments, the Company has entered into a letter of intent with Dr. Fabrizio Rigo, Mrs. Neli da Silva, Rigo Oil Company ("Rigo") and its 100% owned subsidiary, Vega Oil s.r.l. ("Vega"), concerning a proposed business combination of Sheer, Rigo and Vega. Dr. Rigo is the president of both Rigo and Vega and is a geologist with over 50 years of experience in international oil and gas exploration.

Assets held by Rigo will include \$5,000,000 in cash and \$6,000,000 in units of Peyto Energy Trust. Other assets currently held by Rigo include a 37.5% working interest in the Jorf permit onshore Tunisia (989,276 acres), operated by Pioneer Natural Resources Ltd. and a 100% working interest in the Sud Tozeur permit (1,082,283 acres), also onshore Tunisia.

Assets held by Vega include an 85% working interest in the d-490 B.R.-VG permit (31,303 acres) in the shallow Adriatic Sea, offshore East-Central Italy, a 60% working interest in the Civitaquana permit (152,081 acres), onshore Central Italy, a 100% working interest in the Posta Nuova permit (38,154 acres), onshore Southern Italy, and a 30% interest in the Montalbano permit (40,781 acres), also located onshore Southern Italy.

Under the terms of the Letter of Intent, Mrs. Neli da Silva, the spouse of Dr. Rigo, will be issued 55,333,333 common shares of Sheer, at a deemed value of \$0.45 per share and 11,066,666 Series "A" warrants in exchange for all of the issued and outstanding securities of Rigo and all of the issued and outstanding securities of Vega. The Series "A" warrants will entitle the holder to acquire one common share of Sheer at an exercise price of \$0.60 per common share expiring two years from the date of issue. Additionally, Sheer will arrange for a "non-brokered" private placement of 4,444,444 units of Sheer to be issued at \$0.45 per unit for total proceeds of \$2,000,000 with each unit to be comprised of one common share and 0.2 of a Series "A" warrant. First Associates Investments Inc. has been engaged, through an engagement letter dated January 6, 2005, to arrange a "brokered" private placement of up to 6,000,000 common units of Sheer at \$0.60 per unit for total gross proceeds of up to \$3,600,000 with each unit to be comprised of one common share and 0.4 of a Series "B" warrant. The Series "B" warrants will entitle the holder to acquire one common share of Sheer at an exercise price of \$0.80 per common share expiring one year from the date of issue. First Associates Investments Inc., subject to completion of satisfactory due diligence, has also agreed to act as sponsor in connection with the transaction. An agreement to sponsor should not be construed as any assurance with respect to the merits of the transaction or the likelihood of completion.

Under the terms of the Letter of Intent and the "brokered" and "non-brokered" private placements, the total number of issued common shares of Sheer, including the 6,557,863 shares currently outstanding, will be up to 72,335,640 common shares. There will also be 11,955,554 Series "A" warrants and up to 2,400,000 Series "B" warrants. At the time of closing, Sheer will have approximately \$10,400,000 in cash and \$6,000,000 in units of Peyto Energy Trust. Mrs. Neli da Silva will become the controlling shareholders of Sheer with approximately 76.5% ownership. The business combination will be an "arm's length" transaction and will be accounted for as a "reverse takeover".

Completion of the transaction is subject to a number of conditions, including but not limited to, Exchange acceptance and shareholder consent. The transaction cannot close until the required shareholder approval is obtained. There can be no assurance that the transaction will be completed as proposed or at all.

Clearly the successful completion of this transaction will provide Sheer with the opportunity to pursue a number of attractive international exploration opportunities.

MANAGEMENT'S REPORT

To the Shareholders of Sheer Energy Inc.

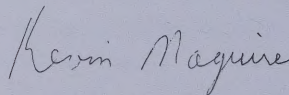
Management is responsible for the preparation of the Financial Statements in accordance with generally accepted accounting principles in Canada. The financial and operating information presented elsewhere in this annual report is consistent with that shown in the financial statements.

Management maintains systems of internal controls to provide reasonable assurance that assets are safeguarded and that relevant and reliable financial information is produced in a timely manner.

Hudson & Company LLP, an independent firm of Chartered Accountants, has been engaged to examine the financial statements. Their report is presented with the financial statements. The Audit Committee of the Board of Directors has reviewed the financial statements with management and the external auditors. The Board of Directors has approved the financial statements on the recommendation of the Audit Committee.



Terrance D. Lawrence
President & C.E.O.



Kevin Maguire
Secretary-Treasurer

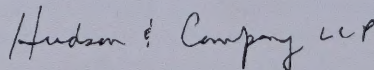
AUDITORS' REPORT

To: The Shareholders of Sheer Energy Inc.

We have audited the consolidated balance sheets of Sheer Energy Inc. (the "Company") as at December 31, 2004 and 2003 and the consolidated statements of operations, retained earnings (deficit) and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Calgary, Alberta
March 4, 2005

HUDSON & COMPANY LLP
Chartered Accountants

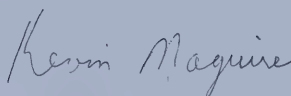
CONSOLIDATED BALANCE SHEETS

December 31	2004	2003
ASSETS		
CURRENT		
Cash	\$ 667,313	\$ 443,454
Accounts receivable	66,593	603,700
Prepaid expenses	19,741	18,116
	753,647	1,065,270
CAPITAL ASSETS (note 3)	810,731	2,488,265
	\$ 1,564,378	\$ 3,553,535
LIABILITIES		
CURRENT		
Bank loan (note 4)	\$ -	\$ 263,377
Accounts payable and accrued liabilities	101,849	546,612
Income taxes payable	449,008	21,676
Bank loans (note 5)	113,083	48,323
Note payable	-	1,328,931
	663,940	2,208,919
FUTURE INCOME TAXES (note 6)	123,521	109,065
ASSET RETIREMENT OBLIGATION (note 7)	73,433	94,927
	860,894	2,412,911
SHAREHOLDERS' EQUITY		
SHARE CAPITAL (note 9)	16,370	1,358,801
CONTRIBUTED SURPLUS (note 10)	-	16,369
RETAINED EARNINGS (DEFICIT)	687,114	(234,546)
	703,484	1,140,624
	\$ 1,564,378	\$ 3,553,535

Approved on behalf of the Board



Director



Director

CONSOLIDATED STATEMENTS OF OPERATIONS

Years ended December 31	2004	2003
REVENUE		
Petroleum and natural gas sales	\$ 584,504	\$ 767,889
Royalties, net of Alberta Royalty Tax Credit	(99,537)	(138,541)
Interest income	21,434	38
Consulting fees	46,957	—
	553,358	629,386
EXPENSES		
Office	340,523	267,721
Operating costs	154,373	203,036
Amortization, depletion and accretion	76,397	113,455
Interest	15,634	24,571
Stock based compensation (note 10)	—	16,369
	586,927	625,152
EARNINGS (LOSS) BEFORE INCOME TAXES	(33,569)	4,234
INCOME TAX (RECOVERY) (note 6)		
Current	(26,942)	33,682
Future	14,456	(24,000)
	(12,486)	9,682
LOSS BEFORE NET INCOME (LOSS) FROM DISCONTINUED OPERATIONS	(21,083)	(5,448)
NET INCOME (LOSS) FROM DISCONTINUED OPERATIONS (note 12)	2,611,375	(99,172)
NET EARNINGS (LOSS)	\$ 2,590,292	\$ (104,620)
BASIC AND DILUTED EARNINGS PER SHARE FROM CONTINUING OPERATIONS (note 13)	\$ (0.003)	\$ (0.001)
BASIC AND DILUTED EARNINGS (LOSS) PER SHARE FROM DISCONTINUED OPERATIONS (note 13)	\$ 0.426	\$ (0.016)

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS
(DEFICIT)

Years ended December 31	2004	2003
DEFICIT, beginning of year		
As previously stated	\$ (244,089)	\$ (143,003)
Effect of change in accounting policy (note 11)	9,543	13,077
As restated	(234,546)	(129,926)
Net earnings (loss)	2,590,292	(104,620)
	2,355,746	(234,546)
Dividends (note 9)	(1,635,466)	—
Premium on return of paid-up-capital (note 9)	(33,166)	—
RETAINED EARNINGS (DEFICIT), end of year	\$ 687,114	\$ (234,546)

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Net earnings (loss) from continuing operations	\$ (21,083)	\$ (5,448)
Items not affecting cash		
Amortization, depletion and accretion	76,397	113,455
Future income taxes	14,456	(24,000)
Stock compensation expense	—	16,369
	69,770	100,376
Changes in non-cash working capital items (note 14)	(135,712)	(39,447)
	(65,942)	60,929
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds on disposal of capital assets	—	128,000
Purchase of capital assets	(75,164)	(50,166)
	(75,164)	77,834
CASH FLOWS FROM FINANCING ACTIVITIES		
Mortgage advances	90,011	—
Mortgage repayments	(25,251)	(159,204)
Asset retirement obligation	(44,340)	(13,205)
Issuance of share capital	247,500	—
	267,920	(172,409)
CHANGE IN CASH POSITION, from continuing operations	126,814	(33,646)
CHANGE IN CASH POSITION, from discontinued operations (note 12)	360,422	286,987
CASH (DEFICIENCY), beginning of year	180,077	(73,264)
CASH, end of year	\$ 667,313	\$ 180,077
CASH CONSISTS OF:		
Cash	\$ 667,313	\$ 443,454
Bank loan	—	(263,377)
	\$ 667,313	\$ 180,077

OTHER INFORMATION (note 14)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2004 and 2003

1. GENERAL

Sheer Energy Inc. (the "Company") was formed, under the laws of the Province of Alberta, at the close of business on December 31, 1998 pursuant to an amalgamation agreement between Sheer Energy Inc. and its wholly owned subsidiary, Krystal Energy Limited. The business of the Company is the exploration, acquisition, development and production of petroleum and natural gas reserves through joint venture arrangements.

2. SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared using the historical cost basis in accordance with Canadian generally accepted accounting principles. These financial statements have, in management's opinion, been properly prepared within the framework of the accounting policies summarized as follows:

Consolidation

The consolidated financial statements include the accounts of Sheer Energy Inc. and its wholly owned subsidiary Sheer Energy (Cyprus) Limited. The subsidiary was incorporated as a limited liability company in the Republic of Cyprus on July 27, 2000. Significant intercompany balances and transactions have been eliminated.

The subsidiary was sold to outside interests on August 19, 2004. This subsidiary has therefore been accounted for as a discontinued operation. Current year operations include only the results of operations up to that date, and have been separated from results of operations from continuing operations (see note 12).

Measurement uncertainty

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. The amount recorded for the provision of income taxes and amortization and depletion of the petroleum and natural gas properties and the accretion of asset retirement obligations are based on estimates of reserves, production rates, petroleum and natural gas prices, future costs, and other applicable factors. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements of future years could be material.

Cash

Cash and equivalents consist of funds on deposit and the balance of a demand revolving operating loan available by way of account overdraft.

Capital assets

The Company follows the full cost method of accounting whereby all costs related to the acquisition and development of oil and gas reserves are initially capitalized. Such costs include lease acquisition costs, geological and geophysical expenditures, lease rentals on non-productive properties, costs of drilling both productive and non-productive wells, equipment costs and general and administrative expenses applicable to these activities.

Costs of acquiring and evaluating unproved properties are initially excluded from the costs subject to depletion and amortization. These properties are assessed regularly to ascertain whether impairment has occurred. When production commences or the property is considered to be impaired, the cost of the property or the amount of impairment is added to the costs subject to depletion and amortization.

Proceeds from disposal of properties will normally be applied as a reduction of the cost of the remaining assets unless the disposal results in a change in the depletion rate by more than twenty percent in which case a gain on loss or disposal will be recorded.

Depletion of exploration and development costs and amortization of production equipment is provided using the unit-of-production method based upon estimated net proven petroleum and natural gas reserves before the deduction of royalties. The costs of significant unevaluated properties are excluded from costs subject to depletion. For depletion and amortization purposes, relative volumes of petroleum and natural gas production and

reserves are converted to equivalent oil on the basis of six thousand cubic feet of natural gas being equivalent to one barrel of oil.

Amortization of office equipment is provided using the declining balance method at an annual rate of 20%.

Amortization of the office condominium is provided using the declining balance method at an annual rate of 4%.

Ceiling test

Effective January 1, 2004 the Company adopted Accounting Guideline 16, "Oil and Gas Accounting – Full Cost" ("AcG-16"), which replaces Accounting Guideline 5, "Full Cost Accounting in the Oil and Gas Industry". AcG-16 modifies how the ceiling test is performed and is consistent with CICA section 3063, "Impairment of Long-lived Assets". The recoverability of a cost centre is tested by comparing the carrying value of the cost centre to the sum of the undiscounted cash flows expected from the cost centre's use and eventual disposition. If the carrying value is unrecoverable the cost centre is written down to its fair value using the expected present value approach. This approach incorporates risks and uncertainties in the expected future cash flows which are discounted using a risk free rate. The adoption of AcG-16 had no effect on the Company's financial results.

Asset retirement obligations

Effective January 1, 2004, the Company retroactively adopted the Canadian accounting standard for accounting for asset retirement obligations as outlined in the CICA Handbook section 3110. The standard requires that the fair value of an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The present value of the estimated asset retirement cost is capitalized as part of the carrying amount of the long-lived asset. The amortization of the capitalized asset retirement cost will be determined on a basis consistent with amortization and depletion. With the passage of time, accretion will increase the carrying amount of the asset retirement obligation. Previously, the Company used the unit of production method to match estimated future retirement costs with the revenues generated from the producing assets. The impact of this change has been disclosed in note 11.

Joint ventures

The Company's exploration, development and production activities are conducted jointly with others and, accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

Foreign currency translation

Monetary assets and liabilities of the Corporation which are denominated in foreign currencies are translated at year-end exchange rates. Other assets and liabilities are translated at rates in effect at the date the assets were acquired and liabilities incurred. Revenue and expenses are translated at the rates of exchange in effect at their transaction dates. The resulting gains or losses are included in operations.

Future income taxes

The Company follows the asset and liability method of accounting for income taxes. Under this method, the change in the future tax asset and liability is to be included in income. Future tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled.

The balance of future income taxes at December 31, 2004 consists mainly of the net book value of capital assets in excess of the undepreciated capital cost and unused resource deductions, which arise from the difference between the Company's amortization and depletion rates and those prescribed for income tax purposes, and accretion of asset retirement obligations that have been expensed for accounting purposes but are only deductible for tax purposes in the year incurred.

Stock-based compensation

The Company has a stock-based compensation plan, which is described in note 9. Under this standard, the Company now accounts for stock options granted since January 1, 2003 using the fair value method. Under this method, compensation expense for stock options granted since January 1, 2003 is measured at the fair value at the grant date using the Black-Scholes valuation model and is recognized over the vesting period of the

options granted. Amounts expensed under this policy are credited to contributed surplus. When the options are exercised, this amount will be transferred to share capital.

Earnings (loss) per share

Basic earnings (loss) per common share are calculated using the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per common share are presented using the treasury stock method and are calculated by dividing net earnings (loss) applicable to common shares by the sum of the weighted average number of common shares outstanding and all additional common shares that would have been outstanding if potentially dilutive common shares had been issued. Earnings (loss) per share information has been separated between continuing and discontinued operations (see note 13).

3. CAPITAL ASSETS

		2004		
	Cost	Accumulated Amortization	Net	
Office equipment	\$ 26,694	\$ 15,220	\$ 11,474	
Producing petroleum and natural gas properties and related equipment	1,509,047	880,017	629,030	
Office condominium	196,358	26,131	170,227	
	\$ 1,732,099	\$ 921,368	\$ 810,731	

		2003		
	Cost	Accumulated Amortization	Net	
Office equipment	\$ 26,514	\$ 12,396	\$ 14,118	
Producing petroleum and natural gas properties and related equipment	1,416,723	819,229	597,494	
Non-producing petroleum and natural gas properties	1,699,146	—	1,699,146	
Office condominium	196,538	19,031	177,507	
	\$ 3,338,921	\$ 850,656	\$ 2,488,265	

4. BANK INDEBTEDNESS

The bank credit facility allows for a \$150,000 operating line available by way of account overdraft to assist with the acquisition and development of oil and gas reserves. The operating line bears interest at the bank's prime rate plus 1% and is secured as disclosed in note 5.

5. BANK LOANS

	2004	2003
Office condominium mortgage, due on demand, with payments of \$2,250 monthly plus interest calculated at the bank's prime rate plus 1% per annum	\$ 113,083	\$ 48,323
Estimated principal repayments are as follows:		
2006	\$ 27,000	
2007	27,000	
2008	27,000	
2009	27,000	
Subsequent years	5,083	
	\$ 113,083	

Subject to a new credit agreement ratified on February 10, 2004, the Company amended its credit facilities. Funds were advanced under the new agreement on March 19, 2004. Under the new facility, the Company has the following available:

- a) Office condominium mortgage, as above.
- b) Operating loan up to \$150,000 available by way of account overdraft. The loan is due on demand by the bank with interest paid at the bank's prime rate plus 1% per annum.

The loans are secured by a debenture and general security agreement with a fixed and floating charge over all assets and an assignment of all risk insurance proceeds, and an environmental indemnity.

6. FUTURE INCOME TAXES

- a) The components of future income tax balances are as follows:

	2004	2003
Future income tax asset		
Share issue costs	\$ (438)	\$ (674)
Asset retirement obligation	(27,625)	(27,776)
Other	(33)	—
Future income tax liability		
Carrying amount of capital assets in excess of tax basis	151,617	137,515
	<u>\$ 123,521</u>	<u>\$ 109,065</u>

- b) The provision for income taxes recorded in the financial statements differs from the amount which would be obtained by applying the statutory income tax rate of 37.62% (2003 – 40.62%) to the earnings (loss) for the years as follows:

	2004	2003
Earnings (loss) for the year before income taxes and discontinued operations	\$ (33,569)	\$ 4,234
Anticipated income tax expense (recovery)	\$ (12,629)	\$ 1,720
Non-deductible stock-based compensation	—	6,649
Non-deductible crown charges and other payments	18,991	35,641
Federal resource allowance	(4,610)	(22,814)
Alberta Royalty Tax Credit	(3,350)	(13,121)
Effect of change in income tax rates	(8,761)	—
Other	(2,127)	1,607
Provision for income taxes	<u>\$ (12,486)</u>	<u>\$ 9,682</u>

7. ASSET RETIREMENT OBLIGATION

The estimated cash flows of asset retirement obligations have been discounted at eight percent. The total undiscounted amount of the estimated cash flows required to settle the obligations is \$125,851.

The following table reconciles the Company's total asset retirement obligations:

	2004	2003
Balance, beginning of period	\$ 94,927	\$ 93,074
Settlement of obligations during period	(44,340)	(13,205)
Accretion expense	5,685	15,058
Increase in obligation	17,161	—
Balance, end of period	<u>\$ 73,433</u>	<u>\$ 94,927</u>

8. RELATED PARTY TRANSACTIONS

Included in general and administrative expense are consulting fees of \$175,500 (2003 – \$175,500) paid to companies controlled by officers and directors of the Company. Accounts payable includes \$7,490 (2003 – \$35,310) payable to directors and companies controlled by directors. The fees were paid in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

Fees of \$713,432 were paid to a director, who was the project manager for the Masjed-I-Suleyman project in Iran (Sheer Cyprus), for consulting services and the termination of the consulting contract, pursuant to its terms. This amount has been deducted from the proceeds of Sheer Cyprus (see note 12).

9. SHARE CAPITAL**a) Authorized**

Unlimited number of common voting shares

Unlimited number of first preferred non-voting shares

b) Issued

	2004		2003	
	Issued	Amount	Issued	Amount
Balance at beginning	6,057,863	\$ 1,358,801	6,057,863	\$ 1,358,801
Stock options exercised	500,000	247,500	–	–
Contributed surplus reclassified to share capital pursuant to exercise of stock options	–	16,369	–	–
Reduction of share capital pursuant to return of paid-up-capital	–	(1,606,300)	–	–
	6,557,863	\$ 16,370	6,057,863	\$ 1,358,801

On October 18, 2004, 134,000 stock options were exercised at \$0.25 each, for total proceeds of \$33,500.

On November 15, 2004, 350,000 stock options were exercised at \$0.60 each, for total proceeds of \$210,000.

On November 26, 2004, a dividend of \$0.25 per share was paid to shareholders of record as of November 18, 2004 in the amount of \$1,635,466.

On December 2, 2004, 16,000 stock options were exercised at \$0.25 each, for total proceeds of \$4,000. \$16,369 that had previously been credited to contributed surplus when the options were issued, was credited to share capital.

On December 31, 2004, a return of paid-up-capital of \$0.25 per share was paid to shareholders of record as of December 17, 2004 for a total cost of \$1,639,466. The Company recognized a premium of \$33,166 over the stated capital as a reduction of retained earnings.

c) Stock options

The Company adopted a stock option plan in May 1997 in order to assist in attracting, retaining and motivating directors, officers, key employees and consultants of the Company. Under the plan a maximum amount equal to 10% of the issued and outstanding common shares of the Company may be reserved for issuance pursuant to stock options provided that no individual could be granted options in excess of 5% of the outstanding common shares of the Company. The Board of Directors determines the exercise price of the optioned shares however, that price cannot be less than the closing market price of the common shares of the Company on the trading day immediately prior to the grant less the maximum discount permitted by regulation. All options have a maximum expiry date of the fifth anniversary of the grant date.

On June 20, 2003, the Company granted 70,000 stock options with an exercise price of \$0.25 to a director of the Company. These options vested immediately. The value of these options (\$16,369) is based on the fair value of the of the vested options on the grant date. The Black-Scholes option pricing model was used to generate the fair value. The assumptions used were as follows:

Risk free interest rate	3.5%
Expected life	5 years
Expected volatility	162%
Dividend yield	0%

As a result, \$16,369 for the 2003 grant was recorded as an expense with a corresponding credit to contributed surplus.

A summary of the Company's director, officer and key employee share options at December 31, 2004 and 2003 and the changes for the years ending on those dates is presented below:

	2004		2003	
	Number of options	Weighted average share price	Number of options	Weighted average share price
Balance at beginning of year	500,000	\$ 0.49	430,000	\$ 0.53
Granted	—	—	70,000	0.25
Exercised	(500,000)	(0.49)	—	—
Balance, end of year	—	\$ —	500,000	\$ 0.49

There are no stock options outstanding or exercisable at December 31, 2004.

10. CONTRIBUTED SURPLUS

The following table reconciles the Company's contributed surplus:

	2004	2003
Balance, beginning of year	\$ 16,369	\$ —
Stock options issued June 20, 2003 (note 9)	—	16,369
Contributed surplus reclassified to share capital pursuant to exercise of stock options	(16,369)	—
	\$ —	\$ 16,369

11. EFFECT OF CHANGE IN ACCOUNTING POLICY

The following details the effect of the change in accounting policy for asset retirement obligations on the balance sheet, as at December 31, 2003:

	As originally reported	Change	Restated balance
Capital assets	\$ 2,455,716	\$ 32,549	\$ 2,488,265
Asset retirement obligations	—	94,927	94,927
Future site restoration	71,921	(71,921)	—
Deficit	(244,089)	9,543	(234,546)

The following details the effects of the change in accounting policy for asset retirement obligations on the statement of operations, for the year ended December 31, 2003:

	As originally reported	Change	Restated balance
Amortization, depletion and accretion	\$ 93,921	\$ 19,534	\$ 113,455
Provision for site restoration	16,000	(16,000)	—
Loss	(101,086)	(3,534)	(104,620)

12. DISCONTINUED OPERATIONS

On August 18, 2004, pursuant to an agreement dated May 25, 2004, the Company sold all of its shares of its wholly-owned subsidiary, Sheer Energy (Cyprus) Limited ("Cyprus"). Out of the net proceeds of \$5,415,831, the Company repaid the note payable relating to the subsidiary operations of \$1,328,931. The Canadian taxes on the gain are \$505,932.

Net results of discontinued operations are as follows:

	2004	2003
Revenue	\$ —	\$ 6
General and administration	77,446	117,032
Interest	79,063	36,093
Foreign exchange (gain)	139,323	(53,947)
Loss from discontinued operations, before the following items	(295,832)	(99,172)
Gain on sale of subsidiary	3,413,139	—
Income tax related to gain	(505,932)	—
	2,907,207	—
Net income (loss) from discontinued operations	\$ 2,611,375	\$ (99,172)

Cash used for discontinued operations is as follows:

Operating activities	\$ (833,297)	\$ (100,688)
Investing activities	5,797,582	(941,256)
Financing activities	(4,603,863)	1,328,931
Cash from discontinued operations	\$ 360,422	\$ 286,987

13. EARNINGS (LOSS) PER SHARE

Basic earnings per share is calculated using the weighted average number of shares outstanding during the year. Diluted earnings per share is calculated to reflect the dilutive effect of stock options outstanding. Earnings per share is calculated as follows:

	2004		
	Net earnings (loss)	Weighted average common shares	Earnings (loss) per share
Basic and diluted loss per share from continuing operations	\$ (21,083)	6,130,213	\$ (0.003)
Basic and diluted earnings per share from discontinued operations	2,611,375	6,130,213	0.426
	\$ 2,590,292	—	\$ 0.423

	2003		
	Net earnings (loss)	Weighted average common shares	Earnings (loss) per share
Basic and diluted loss per share from continuing operations	\$ (5,448)	6,057,863	\$ (0.001)
Basic and diluted loss per share from discontinued operations	(99,172)	6,057,863	(0.016)
	\$ (104,620)	–	\$ (0.017)

14. STATEMENT OF CASH FLOWS

Changes in non-cash working capital items	2004	2003
Accounts receivable	\$ 2,275	\$ 63,363
Prepaid expenses	(1,625)	4,111
Accounts payable and accrued liabilities	(57,762)	(104,597)
Income taxes	(78,600)	(2,324)
	\$ (135,712)	\$ (39,447)

OTHER INFORMATION

Interest paid – continuing operations	\$ 15,634	\$ 24,571
Interest paid – discontinued operations	79,063	36,093
Income taxes paid – continuing operations	51,038	24,403

15. FINANCIAL INSTRUMENTS

Financial instruments consist of recorded amounts of accounts receivable which will result in future cash receipts, as well as a bank indebtedness, accounts payable, notes payable and bank loans which will result in future cash outlays. In management's opinion, the carrying value of these financial instruments approximates their fair value due to the short term maturity.

The Company is exposed to the following risks in respect of certain of the financial instruments held:

(a) Credit risk

Credit risk arises from the possibility that the entities to which the Company sells its oil and gas production to may experience difficulty and be unable to fulfil their obligations. The Company is exposed to financial risk that arises from the credit quality of the entities to which it provides services. However, due to the credit quality of the entities to which the Company sells to, credit risk is minimized.

(b) Interest rate risk

Interest rate risk arises from the possibility that the value of, or cash flows related to, a financial instrument will fluctuate as a result of changes in market interest rates. The Company is exposed to financial risk that arises from the interest rate differentials between the market interest rate and the rates used on their financial instruments.

The bank indebtedness and bank loans bear a variable interest rate of prime plus 1%. The effective interest rate realized during the year was 5.44% (2003 – 6.4%). The average interest rate was 5.0% (2003 – 5.7%).

(c) Currency risk

Currency risk is the risk to the Company's earnings that arises from fluctuations of foreign exchange rates and the degree of volatility of these rates. The Company is no longer exposed to foreign currency fluctuation in relation to its wholly owned subsidiary Sheer Energy (Cyprus) Limited, as this subsidiary was sold (see note 12) on August 19, 2004. Changes in the US dollar effected earnings up to this date.

16. SUBSEQUENT EVENTS

On January 7, 2005, the Company entered into a letter of intent with Farmkey Investment Company ("Farmkey") concerning a proposed business combination of Sheer and the 100% controlled subsidiaries of Farmkey, Rigo Oil Company Ltd. ("Rigo") and Vega Oil s.r.l. ("Vega"). Farmkey and Rigo are private companies incorporated in Jersey and the Channel Isles, respectively, and Vega is a private company incorporated in Italy. The transaction is to be structured by way of a share purchase whereby Sheer Energy Inc. will acquire all of the issued and outstanding shares of Rigo and Vega from Farmkey in exchange for common shares of Sheer. After completion of the proposed business combination, which will be accounted for as a reverse take-over, Farmkey will own approximately 71% of the outstanding shares of Sheer Energy Inc.

17. COMPARATIVE FIGURES

The financial statements have been reclassified, where applicable, to conform to the presentation used in the current year. The changes do not affect prior year earnings.

CORPORATE INFORMATION

Officers and Directors

Terrance D. Lawrence
President, C.E.O. and Director

Dario. E. Sodero
Vice President and Director

Kevin M. Maguire
Secretary-Treasurer and Director

Ali S. Rawji, C.A., C.F.A.
Director

Andrew S. Burgess, C.A.
Director

Bankers

HSBC Bank Canada
407 – 8th Avenue S.W.
Calgary, Alberta T2P 1E5

Stock Exchange Listing

TSX Venture Exchange
Symbol "SHU"

Auditors

Hudson & Company LLP
#300, 625 – 11th Avenue S.W.
Calgary, Alberta T2R 0E1

Solicitors

Fraser Milner Casgrain LLP
30th Floor, Fifth Avenue Place
237 – 4th Avenue S.W.
Calgary, Alberta T2P 4X7

Transfer Agent

Computershare Trust
Company of Canada
Calgary, Alberta

Head Office

Suite 106, 138 – 18th Avenue S.E.
Calgary, Alberta T2G 5P9
Phone: (403) 802-6983
Facsimile: (403) 802-6984

Website

www.sheerenergyinc.com

Sheer Energy Inc.

Suite 106, 138 – 18th Avenue S.E.

Calgary, Alberta T2G 5P9

Phone: (403) 802-6983

Facsimile: (403) 802-6984

www.sheerenergyinc.com